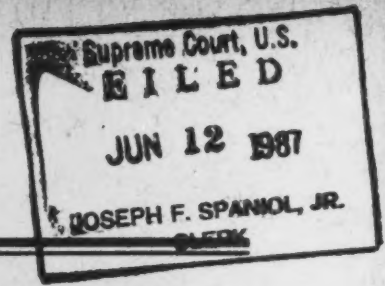


(4)
No. 86-1647



In the Supreme Court of the United States
OCTOBER TERM, 1986

HARRISON J. GOLDIN, COMPTROLLER OF THE
CITY OF NEW YORK, ET AL., PETITIONERS

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED

Solicitor General

MICHAEL C. DURNEY

Acting Assistant Attorney General

ERNEST J. BROWN

THOMAS R. LAMONS

Attorneys

Department of Justice

Washington, D.C. 20530

(202) 633-2217

14 pp

QUESTION PRESENTED

Section 86 of the Internal Revenue Code provides that Social Security recipients who have substantial amounts of other income must include in their gross income for tax purposes up to one-half of the Social Security benefits that they receive. The question presented is whether Section 86 is unconstitutional because the measure of the other income that triggers the tax on Social Security benefits includes interest on municipal bonds.

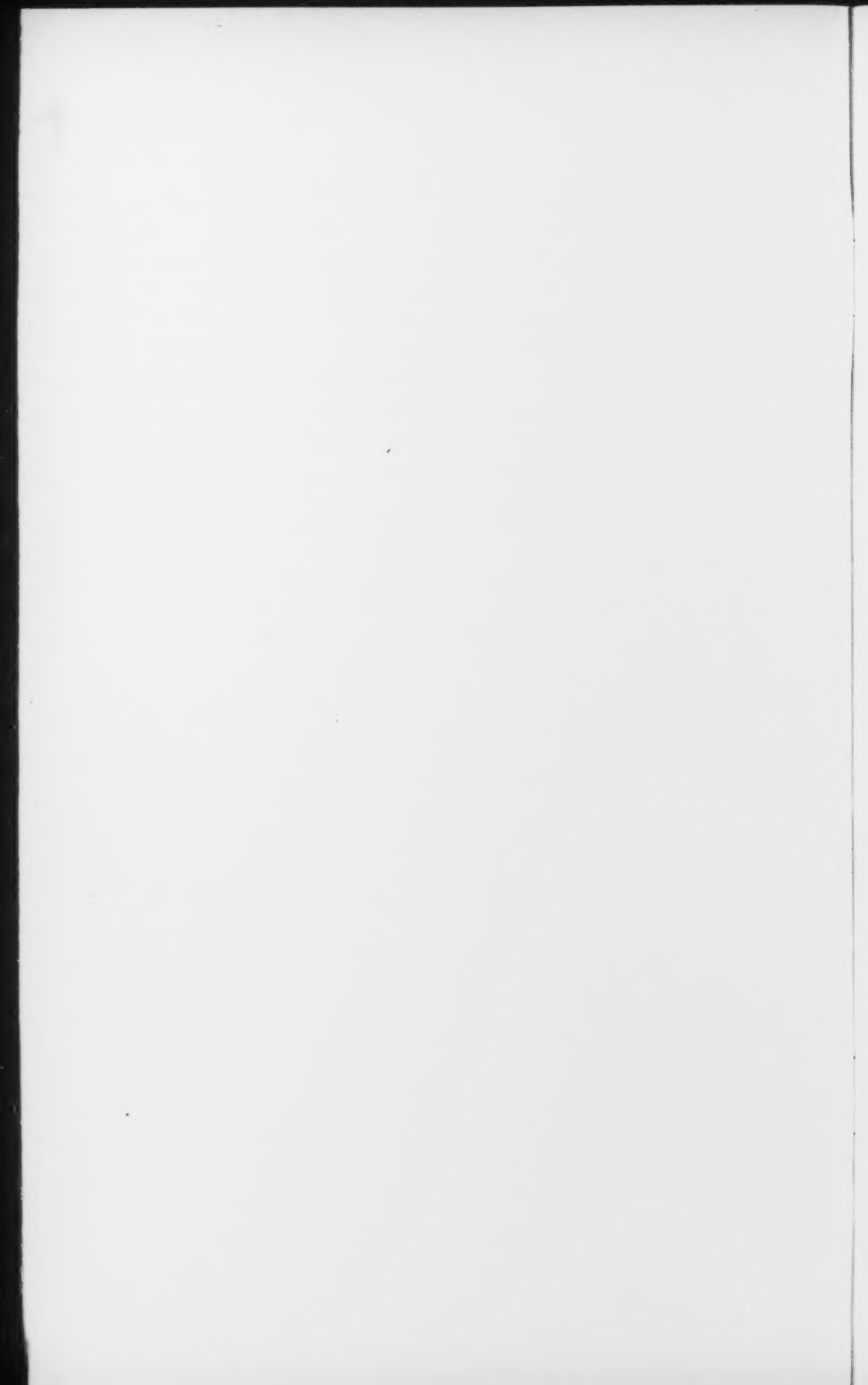


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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-17) is reported at 809 F.2d 187. The opinion of the district court (Pet. App. 19-29) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on January 12, 1987. The petition for a writ of certiorari was filed on April 12, 1987. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 86 was added to the Internal Revenue Code¹ by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 121, 97 Stat. 80. It was enacted to strengthen the Social Security system by requiring taxpayers who have substantial income from other sources to pay a tax on a portion of their Social Security benefits. See S. Rep. 98-23, 98th Cong., 1st Sess. 25-28 (1983). The portion subject to tax may in no event exceed 50%—the portion that corresponds to FICA taxes paid by the employer rather than by the employee. In order to alleviate any burden on the neediest recipients of Social Security, the tax is “phased in” by having the percentage of benefits subject to tax increase from 0% to 50% as the recipient’s other income goes up.

The phase-in is accomplished by a statutory formula under which the taxpayer must determine whether his “modified adjusted gross income,” plus one-half of his Social Security benefits, exceeds a specified “base amount.” If it does, a portion of his Social Security benefits, up to one-half of those benefits, must be included in gross income for tax purposes.² The “base amount” is \$32,000 for taxpayers filing a joint return and \$25,000 for most other taxpayers (I.R.C. § 86(c)).

¹ Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

² The amount included in gross income is the lesser of:
(i) one-half of the Social Security benefits received; or
(ii) one-half of the amount by which the taxpayer’s “modified adjusted gross income” plus one-half of his Social Security benefits exceeds his base amount. I.R.C. § 86(a). See Pet. App. 7-8 (giving examples).

Section 86(b)(2) defines "modified adjusted gross income" in a manner designed to reflect the taxpayer's true economic income in order to accomplish the legislative purpose of sparing only relatively needy Social Security recipients from taxation of their benefits. Section 86(b)(2)(A) accordingly provides that "modified adjusted gross income" includes several varieties of income that are exempt from tax, such as certain income from sources outside the United States.³ In addition, and most relevant for present purposes, Section 86(b)(2)(B) provides that the term also includes "the amount of interest received or accrued by the taxpayer * * * which is exempt from tax."

2. Petitioners issue municipal bonds the interest on which is exempt from tax under Section 103 of the Code. They brought this suit in the United States District Court for the Southern District of New York to challenge the constitutionality of Section 86. Petitioners argued that the inclusion of tax-exempt interest income in "modified adjusted gross income" is, in effect, a tax on the income from municipal bonds. This argument was based on the fact that, in certain circumstances, Section 86 may cause a recipient of municipal bond income to be taxed on a

³ Section 86(b)(2)(A) provides that "modified adjusted gross income" means "adjusted gross income" (as defined in I.R.C. § 62) without regard to the following deductions or exclusions listed in Section 86(b)(2)(A): (i) the deduction for two-earner married couples (I.R.C. § 221); (ii) the exclusion of foreign earned income (I.R.C. § 911); (iii) the exclusion of income of United States citizens who derive a certain percentage of their income from sources within United States Possessions (I.R.C. § 931); and (iv) the exclusion of income for residents of Puerto Rico (I.R.C. § 933).

portion of his Social Security benefits, whereas he would not be so taxed in the absence of such tax-exempt income. Petitioners contended that this statutory scheme violates constitutional principles of intergovernmental tax immunity and hence exceeds the authority of the United States to "lay and collect taxes" contained in Article I, Section 8 of the Constitution. Petitioners also argued that Section 86 violates the Tenth Amendment by impairing the sovereign functions of state and local governments.

The district court issued an oral opinion (Pet. App. 19-29) granting the government's motion to dismiss the suit for failure to state a claim.⁴ The court first observed (*id.* at 25-26) that petitioners placed their chief reliance on the version of the tax immunity doctrine announced in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), where this Court held that the federal government may not lay a direct tax on interest income received by municipal bondholders. "There is," the district court pointed out, "a progression from the time of *Pollock* to the present time which has served considerably to narrow the concept in practice of intergovernmental tax immunity" (Pet. App. 25-26).

The district court found it unnecessary to determine precisely what remains of the *Pollock* doctrine, however, because it held that Section 86 does not impose any tax whatsoever on municipal bond interest income. The court explained that Section 86 was designed to help strengthen the "shaky financial

⁴ The court at the same time denied the government's motion to dismiss for lack of standing (Pet. App. 20-24). The government did not renew its standing argument in the court of appeals.

status of the social security system" by "requir[ing] taxpayers who have a comfortable flow of income to pay a tax on some part of the social security payments which they receive" (Pet. App. 27). The fact that municipal bond interest income is one component of a taxpayer's "total income flow" does not, in the court's view, render the tax imposed by Section 86 "a tax on tax exempt income" (Pet. App. 28). The court acknowledged that Section 86's mode of determining when and to what extent Social Security benefits are taxed might conceivably have some effect on municipal finances. But it explained that this consequence is no more a constitutional problem than Congress's taxation of the salaries of municipal employees, which surely has a substantial adverse impact on municipal finances.

3. The court of appeals unanimously affirmed (Pet. App. 1-17). It noted that, in light of subsequent decisions by this Court, it is "questionable" whether the decision in *Pollock* was still good law (Pet. App. 9-10). Like the district court, however, the court of appeals determined that it need not reach that issue because Section 86 does not impose a tax upon interest paid by local governments, but instead imposes a tax upon Social Security benefits received by individual taxpayers from the federal government (Pet. App. 10). The court acknowledged that a person's receipt of tax-exempt interest income, like his receipt of other varieties of taxable and tax-exempt income, will in certain cases affect the taxability of his Social Security benefits. Citing *United States v. Atlas Life Ins. Co.*, 381 U.S. 233 (1965), however, the court explained that such an indirect tax consequence of receiving tax-exempt income cannot be equated with a direct tax upon that income

(Pet. App. 11-12). Finally, the court concluded that petitioners' Tenth Amendment argument "merits little discussion" because the power to tax private income has expressly been delegated to Congress and, moreover, because there is no support for the view that Section 86 impairs the ability of state governments, or political subdivisions thereof, to function effectively in the federal system (Pet. App. 16-17).

ARGUMENT

Petitioners' contention that Section 86 violates constitutional principles of intergovernmental tax immunity was correctly rejected by both courts below. Petitioners do not allege, nor is there, any conflict among the circuits on the questions presented,⁵ and there is likewise no conflict with any decision of this Court. There is, accordingly, no reason for further review.

1. Whatever the conclusion regarding the constitutionality of a direct federal tax on municipal bond income, there is no basis for concluding that Section 86 of the Code exceeds Congress's constitutional power. Section 86 does not impose a tax on income from municipal bonds. It taxes only Social Security benefits; in the absence of receipt of such benefits no tax is imposed.

It is true that Section 86 does take account of municipal bond income in determining whether and to what extent a tax on Social Security benefits will

⁵ Petitioners' claim has been advanced in three other lawsuits. See Pet. 32 n.4. It has not been accepted by any court, and it has been rejected on the merits by the Claims Court; no other court of appeals has yet considered it.

be triggered.⁶ But it is well established that such an attenuated effect of the receipt of municipal bond income on the taxability of other income raises no serious constitutional question. In *United States v. Atlas Life Ins. Co.*, 381 U.S. 233 (1965), this Court upheld a statute that, like Section 86, had the effect in certain circumstances of increasing the tax on a taxpayer's other income because of an increase in its receipt of tax-exempt income. The statute at issue there required life insurance companies to allocate a pro rata share of all their income, including their tax-exempt income, to insurance reserves. Because income attributed to life insurance reserves was non-taxable under separate provisions of the Code, the taxpayer pointed out that the required pro rata allocation had the effect of increasing the tax on its other income, since every dollar of municipal bond income allocated to its reserves would drive a dollar of other income out of the reserves and into the taxable category. The taxpayer therefore contended that the statute, by thus increasing its tax liability over what it otherwise would have been, in effect imposed an unconstitutional tax on its municipal bond interest.

This Court squarely rejected the insurance company's argument, holding that this indirect effect on its tax liability was not impermissible and reasoning that there is no constitutional impediment to "the principle of charging exempt income with a fair

⁶ It is, however, only a "fairly narrow group of taxpayers" (Pet. App. 8) for whom Section 86 is likely to cause the receipt of tax-exempt income to have some effect on their federal tax bill. That "narrow group" is composed of those Social Security recipients whose other income, excluding the adjustment for tax-exempt income, is close to the "base amount" that triggers the tax on Social Security benefits.

share of the burdens properly allocable to it" (381 U.S. at 251). The same reasoning applies here. In a statute designed to tax in part the Social Security benefits of those who can most easily afford it, *i.e.*, those who have a sufficiently high level of other income, it is fair—and constitutional—to include tax-exempt income in the measure of other income that triggers the tax.⁷

The mere fact that there may be a class of taxpayers who, by virtue of Section 86, will conceivably be less inclined to purchase municipal bonds, thereby affecting the marketability of such bonds to some slight degree, is plainly insufficient to make the statute unconstitutional. This Court has upheld federal tax provisions that have a much greater impact on the marketability of state and municipal bonds. See, *e.g.*, *Willcuts v. Bunn*, 282 U.S. 216 (1931) (capital gains from the sale of municipal bonds may constitu-

⁷ The distinction between (1) a direct tax on an amount of income and (2) the use of that amount as a factor in a formula that calculates the tax on a different amount of income, has also been recognized outside the intergovernmental immunity context. This Court has repeatedly held that a state may take into account income or property outside its jurisdiction in computing the tax on income or property within its jurisdiction, even though the Due Process Clause would bar direct taxation of the extra-territorial income or property. See *Great Atlantic and Pacific Tea Co. v. Grosjean*, 301 U.S. 412 (1937); *Maxwell v. Bugbee*, 250 U.S. 525 (1919). And the old add-on minimum tax (26 U.S.C. (1976 ed.) 56) has been upheld against a challenge that it was not a tax on "income" because the formula for determining when the tax was triggered included consideration of items of capital recovery rather than income, such as depletion allowances and accelerated depreciation. See *Trainer v. United States*, 800 F.2d 1086 (Fed. Cir. 1986), cert. denied, No. 86-904 (Mar. 2, 1987).

tionally be subject to federal income taxation); *Greiner v. Lewellyn*, 258 U.S. 384 (1922) (transfers of municipal bonds may constitutionally be subject to federal estate and gift taxation). And, of course, federal income taxation of the salaries of state and local government employees, the constitutionality of which has been clear for almost half a century (see *Helvering v. Gerhardt*, 304 U.S. 405 (1938)), has a much greater impact on local government finances than Section 86 could ever have. In sum, it is clear that the court of appeals correctly held that Section 86 does not exceed Congress's taxing power.⁶

2. For the reasons just discussed, petitioners' suggestion (Pet. 30-33) that the instant petition should be granted so that this case can be heard together with *South Carolina v. Baker*, No. 94, Orig., is manifestly inappropriate. The cases do not present the same question. The statute at issue in *South Carolina*, enacted in 1982, requires that municipal bonds be issued in registered rather than in bearer form in order for the interest paid thereon to be tax-exempt in the hands of the bondholder. See I.R.C. § 103(j). Although no state or local government has issued a registration-required obligation in bearer form, the *South Carolina* case does

⁶ The court of appeals also correctly rejected (Pet. App. 16-17) petitioners' Tenth Amendment claims (see Pet. 27-29). The power to tax private income has been expressly delegated to Congress, and hence the terms of the Tenth Amendment have no application here. And it cannot seriously be contended that the speculative and minor effect of Section 86 on the marketability of municipal bonds impairs the ability of any state "to function effectively in a federal system" (Pet. 29, quoting *Fry v. United States*, 421 U.S. 542, 547 n.7 (1975)).

present, at least theoretically, the question whether Congress may ever impose a tax on municipal bond interest. The instant case, by contrast, does not involve any attempt by Congress to impose a tax on municipal bond interest. Hence, regardless of the outcome of *South Carolina v. Baker*, the court of appeals' decision here was correct.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED

Solicitor General

MICHAEL C. DURNEY

Acting Assistant Attorney General

ERNEST J. BROWN

THOMAS R. LAMONS

Attorneys

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